VI. THE PLAN PROMOTES EFFICIENT DEPLOYMENT OF ADVANCED SERVICES

The Plan is the best available means of promoting the deployment of advanced services in the rural and insular areas served by non-price cap LECs, especially compared to the multiple long-pending Commission proceedings that affect such areas. As the Commission is well aware, the availability of advanced services depends on the presence of up-to-date, new technologies in a provider's network. The Plan provides strong incentives for the deployment of such technologies by Path B LECs as well as Path A LECs, consistent with section 706 of the Act. According to the Vander Weide testimony,

> The Plan offers three sources of enhanced incentives for efficiency and investment in new technologies. First, the Plan requires the non-price cap LECs who choose Path A to move to incentive regulation by the end of a five-year transition period ....
>
> * * * *
>
> Second, the Plan removes the current cap on high cost loop support. Rural telephone companies are a very diverse group. Many are very small companies that serve areas with declining population. These companies simply do not have the financial resources to maintain and upgrade their plant under the current limits on high cost loop support. Removing these limits will allow the rural telephone companies to invest in the new technologies required to bring high quality telecommunications service to rural areas.
>
> Third, the Plan offers an opportunity to settle many complex regulatory issues in the areas of interstate access, universal service support, separations, and rate of return. By settling these issues, the Plan will produce a more stable environment for telecommunications investment by the non-price cap LECs. The risk caused by massive upcoming regulatory changes has encouraged companies in rural study areas to postpone investment. Adoption of the Plan will reduce the uncertainty about these changes.[54]

As a policy matter, the Plan is not designed to change the definition of services eligible for universal service funding to include advanced services.[55] However, as seen above, the Plan

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[54] Vander Weide testimony at pp. 2-18, 2-19.

[55] The Commission recently requested the Joint Board to review the definition of universal service. *Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Order, FCC 00-

will provide incentives for non-price cap LECs to invest in new infrastructure. Such infrastructure will not impede, and will likely be capable of supporting, advanced services as well as services currently supported through the universal service program.

VII. THE PLAN REFORMS THE COMMISSION'S RULES REGARDING MERGERS AND ACQUISITIONS INVOLVING NON-PRICE CAP LECs

The Group urges the Commission to reform its rules regarding mergers and acquisitions involving non-price cap LECs. In general, these rules have the effect of discouraging LECs in rural and insular areas from acquiring and upgrading telephone exchanges. At the same time, the harms they seek to protect against are highly speculative.

In particular, the Commission should eliminate the "all-or-nothing" rule under which a LEC choosing price cap regulation is required to shift all of its affiliates to price cap regulation as well. The Commission adopted this rule in 1993 because it was concerned about potential cost shifting from price-cap-regulated affiliates to rate-of-return-regulated affiliates.[56]

The Group believes that the Plan and the current environment have rendered the all-or-nothing rule obsolete. The Commission's current accounting safeguards and reporting requirements are more than adequate to guard against any such cost-shifting. Where competition

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440 (rel. Dec. 21, 2000). As acknowledged in the Notice, advanced and high-speed services are not currently included within the definition of services supported by the universal service mechanisms, but the Commission's forward-looking high-cost support mechanism for non-rural carriers provides support for infrastructure that does not impede high-speed services. *See Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Report and Order, 12 FCC Rcd 8776, 8822-23, 8913 (1997) (subsequent history omitted); *see also Federal-State Joint Board on Universal Service*, CC Docket No. 96-45, Fifth Report & Order, 13 FCC Rcd 21323, 21352-53 (1998).

[56] *See generally National Rural Telecom Association v. FCC*, 988 F.2d 174, 179 (D.C. Cir 1993).

is occurring in the service areas of rate-of-return LECs, competitive pressures on rates from such competition will reduce any incentives to shift costs to such LECs.

Similarly, the Commission should eliminate the freeze on study area boundaries for non-price cap carriers. As the Notice states, the Commission froze study area boundaries effective November 15, 1984, primarily to ensure that carriers do not place high-cost exchanges in separate study areas to maximize universal service payments.[57] As a practical matter, however, the freeze does very little other than require affected LECs to seek waivers of it from the Commission when they are seeking to merge with or acquire other LEC exchanges or operations. These waiver proceedings introduce delay and unnecessary costs into routine business transactions for little purpose other than to alert the Commission that the transactions are taking place. The Plan's proposed prior notification requirement[58] for such transactions is a far superior way of meeting the Commission's policy goals in this area.

The Plan also advocates elimination of section 54.305 of the Commission's rules. This so-called "parent trap" rule requires carriers that acquire telephone exchanges from unaffiliated carriers to receive universal service support for the acquired exchanges at the same per-line support levels for which those exchanges were eligible prior to the transfer of the exchanges. Although the goal of this rule, when adopted, was to prevent carriers from "placing unreasonable reliance upon potential universal service support in deciding whether to purchase

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[57] The freeze also is intended to prevent transfers of telephone exchanges among existing study areas for the purpose of increasing interstate-allocated revenue requirements and compensation.

[58] *See* proposed amendment to definition of "Study Area" in Part 36, Appendix-Glossary, 66 Fed. Reg. at 7730.

exchanges."[59] There is no indication that such "unreasonable reliance" has ever been a factor in such decisions. In discussing this rule in the context of non-rural carriers, the Joint Board recently noted its infirmities:

> [W]e believe that in practice [section 54.305] has negative consequences, at least with regard to transfers of exchanges between carriers that are not both receiving support based on the forward-looking mechanism. For example, by freezing support based on the seller's embedded costs, the rule prevents the acquiring carrier from receiving an amount of support related to the costs of providing supported services in the transferred exchange. Moreover, the rule requires the acquiring carrier to keep separate books of account for the acquired exchanges for an indefinite period of time. We strongly encourage the Commission to consider an alternative to section 54.305 at the earliest opportunity.[60]

It is clear that section 54.305 effectively discourages non-price cap LECs from acquiring and upgrading inferior telephone exchange plant, contrary to the Act's universal service goals. Elimination of section 54.305, coupled with the Plan's proposed rules for calculating universal service support in merger and acquisition situations, will advance universal service objectives.

VIII. THE PLAN ENFORCES GEOGRAPHIC RATE AVERAGING AND RATE INTEGRATION

The Plan seeks to enforce the geographic averaging requirement of section 254(g) of the Act. Under the Plan, IXCs must pass through to long distance customers the savings that IXCs realize from lower access rates charged by the non-price cap LECs subject to the plan. The Plan eliminates IXCs' minimum monthly charges for long distance service customers in non-price cap LEC service areas. The Plan requires IXCs to offer the same optional calling plans to rural and

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[59] *See Federal-State Joint Board on Universal Service,* First Report and Order, 12 FCC Rcd 8776, 8942-43 (1997).

[60] *Federal-State Joint Board on Universal Service*, Recommended Decision, 15 FCC Rcd 14714, 14723-14724 (Jt. Bd. 2000).

urban customers alike. With the more economically efficient access charges that will result from the Plan, IXCs will more readily be able to satisfy the section 254(g) requirement.

The Group is well aware that, because IXCs are nondominant carriers, the Commission does not actively regulate their rates through the tariff process.[61] However, the Commission has ample authority under the Act to enforce IXCs' obligations pursuant to section 254(g) and regulations that the Commission adopts thereunder. Because public information about IXCs' rates and services will continue to be readily available, either the Commission staff or private parties will be able to initiate enforcement action. The Group urges the Commission to adopt its proposed rule regarding geographic averaging and availability of IXC services and to enforce that rule.

IX. THE PLAN MINIMIZES ADMINISTRATIVE AND REGULATORY BURDENS

For purposes of analysis under the Regulatory Flexibility Act, the Group believes strongly that the Plan will benefit small business entities, including small incumbent LECs, IXCs. and new entrants.[62] The Plan's optionality, including the election by non-price cap LECs of either Path A regulation or Path B regulation, will permit small non-price cap LECs to control their administrative and regulatory burdens by permitting them to analyze and select the type of regulation that best suits their particular situation. The Path A incentive regulation proposed in the Plan provides a means of introducing additional incentives to operate efficiently for those LECs that elect it. Path B regulation, which retains existing forms of rate-of-return regulation,

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61 The Commission is in the process of implementing mandatory detariffing of these carriers' rates. *See* Public Notice, *Common Carrier Bureau Extends Transition Period For Detariffing Consumer Domestic Long Distance Services*, CC Docket No. 96-61, DA No. 01-282 (Com. Car. Bur. rel. Feb. 5, 2001).

62 *See* Regulatory Flexibility Act, 5 U.S.C. §§ 601 *et seq.*

benefits those LECs that are most vulnerable to events, such as the loss of population (and thus customers) in their service areas, that would cause Path A incentive regulation to harm them.

The Plan's continued use of the NECA centralized tariff and pooling system will minimize regulatory and administrative burdens on the Commission, since multiple LECs will utilize the NECA access tariff.

The Plan's adoption of lower per-minute access charges will benefit the smaller IXCs that pay such per-minute charges, as well as the small business customers that use those IXC services. The Plan's use of explicit, portable interstate access support for ETCs will benefit the smaller new entrants into the service areas of non-price cap carriers.

If the Commission were to continue the *status quo* – that is, the existing access charge and universal service fund rules applicable to small non-price cap LECs, and the pending proceedings regarding these rules -- the regulatory uncertainty associated with the pending proceedings would be a continuing major regulatory burden.

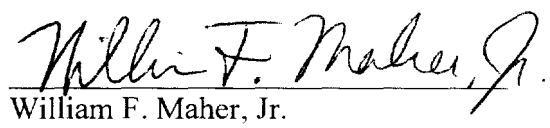
Adopting a portion, or a modified version, of the Plan, would introduce significantly more uncertainty for these small carriers. The Group believes that the unified approach represented by the Plan presents the best way of minimizing regulatory and administrative burdens for small non-price cap LECs. At the same time, the Plan provides major advantages for the other small entities discussed above.

X. CONCLUSION

The Plan presents a major opportunity for the Commission to resolve the numerous regulatory issues facing non-price cap LECs in a cohesive, integrated way. For the reasons stated above, the Group urges the Commission to adopt the Plan as filed.

Respectfully submitted,

LEC MULTI-ASSOCIATION GROUP

By: 

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Dated: February 26, 2001

ATTACHMENT 1

To

Comments of LEC Multi-Association Group

in CC Docket Nos. 00-256, 96-45, 98-77, 98-166

Filed February 26, 2001

MEMORANDUM OF NECA

February 26, 2001

NECA NATIONAL EXCHANGE CARRIER ASSOCIATION INC

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February 16, 2001

TO: National Rural Telecom Association
National Telephone Cooperative Association
Organization for the Promotion and Advancement of Small Telecommunications Companies
United States Telecom Association

RE: Multi-Association Group Plan for Improved Regulation of Non-Price Cap Incumbent Local Exchange Carriers (MAG Plan)

This is in response to your request that NECA address the administrative feasibility of the MAG Plan as filed with the FCC on October 20, 2000, including whether the Path A/Path B two-tiered approach will have any practical or administrative consequences and whether, on balance, the proposed MAG Plan will increase or decrease rate-of-return carriers' administrative burdens.

NECA has worked closely with the Multi-Association Group in providing numerical support for the development of the filed MAG Plan. NECA has also reviewed the Plan in terms of its impact on the interstate access tariffing and pooling processes administered by NECA. The MAG Plan, as filed, is administratively feasible. The Plan is compatible with tariffing and pooling processes administered by NECA, and can be implemented without significant increases in administrative burdens on rate-of-return carriers. The centralized tariff development and pooling approach has worked well for many years in reducing administrative burdens on both carriers and the Commission. The MAG Plan as filed was specifically designed to ensure the continuation of these centralized tariff and pooling benefits.

The MAG Plan proposes that the FCC implement the Plan effective July 1, 2001. Should the Commission issue an order prior to May 15, 2001 adopting the Plan, NECA suggests a phased implementation of the access rate structure changes. Specifically, changes related to the recommended increases in subscriber line charges (SLCs) could go into effect within forty-five days of the Order, allowing NECA time to recalculate revenue and file its revisions on fifteen days notice (*i.e.*, July 1, 2001 in the case of a May 15th Order). However, rate-of-return carriers will require a minimum of 60 days following release of the order to complete the tariff election process, and NECA will require at least 120 days between the election and tariff effective dates for the development of rates, calculation of the Rate Averaging Support (RAS) and modification of pooling processes.

NECA suggests, therefore, in order to allow companies adequate time to make "path" and tariff election decisions and provide sufficient time for NECA to calculate rates and revise pooling procedures, that changes other than those related to SLC increases go into effect no sooner than six months following adoption of revised rules (*i.e.*, January 1, 2002 in the case of an order adopted by May 15, 2001).

Sincerely,

ATTACHMENT 2

To

Comments of LEC Multi-Association Group

in CC Docket Nos. 00-256, 96-45, 98-77, 98-166

Filed February 26, 2001

AFFIDAVIT OF JAMES H. VANDER WEIDE

Originally filed on October 20, 2000
As Exhibit 2 to Petition for Rulemaking of
The LEC Multi-Association Group re

Plan For Improved Regulation
Of
Non-Price Cap Incumbent
Local Exchange Carriers
And Interexchange Carriers

February 26, 2001

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
Improved Regulation of Interstate Services of Non-Price Cap Incumbent Local Exchange Carriers And Interexchange Carriers	)	RM No. _____

AFFIDAVIT OF JAMES H. VANDER WEIDE

Qualifications and Purpose

Q. What is your name and business address?

A. My name is James H. Vander Weide. I am Research Professor of Finance and Economics at the Fuqua School of Business, Duke University. I am also President of Financial Strategy Associates, a firm that provides strategic and financial consulting services to clients in the electric, gas, insurance, telecommunications, and water industries. My business address is 3606 Stoneybrook Drive, Durham, North Carolina.

As a Professor at Duke University, I have taught courses in corporate finance, investment management, management of financial institutions, statistics, economics, and operations research, as well as a Ph.D. seminar on the theory of public utility pricing. I have also been active in executive education at Duke, directing and teaching in executive programs both stateside and abroad for leading international firms. In addition to my teaching, I have written a book entitled, *Managing Corporate Liquidity: An Introduction to Working Capital Management*, and numerous articles and research papers on such topics as portfolio management, the cost of capital, capital budgeting, the effect of

regulation on the performance of public utilities, and cash management. I hold a Ph.D. in finance from Northwestern University and a B.A. in economics from Cornell University.

Q. What is the purpose of your affidavit?

A. The Multi-Association Group has asked me to: (1) review their proposal for regulatory reform; (2) evaluate its consistency with sound economic policy in telecommunications; and (3) make a recommendation to the Commission on whether this proposal should be accepted. From my review of the Multi-Association Group Plan ("the Plan"), I conclude that the Plan furthers the goals of economic policy in telecommunications, and I recommend that the plan be accepted by the Commission.

Economic Policy in Telecommunications

Q. What is the primary objective of economic policy in telecommunications?

A. The primary objective of economic policy in telecommunications is to promote the widespread availability of high quality, reliable telecommunications services at affordable rates.

Q. What policies has the Commission pursued to achieve this objective?

A. The Commission has pursued its economic policy objective in telecommunications by: (1) regulating rates; (2) encouraging competition; (3) providing incentives for efficiency and cost reduction; (4) rebalancing rates; and (5) providing both implicit and explicit support for universal service.

Q. What particular forms of rate regulation has the Commission exercised?

A. The Commission has exercised both rate of return regulation and incentive regulation.

Rate of Return Regulation

Q. What is rate of return regulation?

A. Rate of return regulation is a system of regulation that controls rates by requiring that a company's return on investment be no greater than the return its investors could earn on other investments of similar risk. The first step in rate of return regulation is to measure the company's operating expenses, its investment in plant and equipment, called its rate base, and its fair rate of return on investment. The next step is to determine the company's revenue requirement through the formula:

Revenue Requirement = Operating Expenses + Fair Rate of Return x Rate Base.

Finally, the Commission sets rates for telecommunications services that produce sufficient revenues to allow the company to earn its revenue requirement. The set of rates for specific regulated services that allow the company to earn its revenue requirement is called the rate structure. Under rate of return regulation, the rate structure for regulated services frequently involves pricing some services above cost so as to provide cross subsidies to other regulated services that are priced below cost. These cross subsidies have contributed to the goal of universal service in rural areas as evidenced by the 94 percent penetration of telephone service nationwide.

Q. How does rate of return regulation encourage telecommunications companies to reduce costs, expand services, and invest in new telecommunications technologies?

A. Rate of return regulation encourages efficient behavior primarily through the administration of regulatory oversight. If a company acts efficiently in the production and sale of regulated telecommunications services, it will be able to set rates that are sufficient to recover all operating expenses plus a fair rate of return on the company's investment. If a company acts inefficiently, a portion of its operating expenses or its investment may be disallowed.

Incentive Regulation

Q. What is incentive regulation?

A. Incentive regulation is a form of regulation that further breaks the link between a company's rates and its expenses. Rather than basing rate changes on increases or decreases in a company's own expenses, regulators base rate adjustments on increases or decreases in an external cost standard such as the GDP-PI. By basing rate changes on changes in an external cost standard, incentive regulation shifts the focus from rate of return to increasing efficiency.

Q. What are the major benefits of incentive regulation?

A. Incentive regulation provides enhanced incentives for a company to reduce costs, expand service, and invest in new telecommunications technologies. If the company's efforts to reduce costs, expand service, and invest in new technologies are successful, the company is permitted to earn a higher rate of return. On the other hand, if the company's efforts are unsuccessful, the company's rate of return will be lower. In addition, incentive regulation frequently provides flexibility for the company to price individual services in line with sound business and economic principles, and it reduces the costs of regulation.

Q. What types of "efficiency" does incentive regulation seek to encourage?

A. Incentive regulation seeks to encourage technical efficiency, allocative efficiency and dynamic efficiency. Technical efficiency refers to the ability of a company to use the least amount of inputs, such as labor and capital, for a given level of output. Allocative efficiency refers to the company's ability to set prices for different telecommunications services that reflect the true economic costs of producing those services. Dynamic

efficiency refers to the company's ability to choose the correct level of investment in new technologies and services.

Q. How does incentive regulation encourage technical efficiency?

A. Incentive regulation encourages technical efficiency by breaking the link between the company's revenues and the amount it spends on labor and capital inputs. Under incentive regulation, the company's profits increase whenever it can produce and sell the same level and quality of services with fewer labor and capital inputs. Likewise, its profits decrease whenever the company uses too many labor and capital inputs to produce telecommunications services.

Q. How does incentive regulation encourage allocative efficiency?

A. Incentive regulation encourages allocative efficiency by giving companies the flexibility to more closely align rates with the manner in which costs are incurred. Thus, incentive regulation generally produces rates that provide stronger economic signals to customers about the level of society's resources they are consuming. Economic theory suggests that stronger price signals lead to a more efficient allocation of society's resources.

Q. How does incentive regulation encourage dynamic efficiency?

A. As noted above, dynamic efficiency refers to the company's ability to choose the correct level of investment in new technologies and services. Companies have an incentive to invest in new technologies and services whenever the expected rate of return from such investments exceeds the cost of capital. Since incentive regulation focuses on efficiency rather than rate of return, it places no limits on the return companies can achieve by investing in new technologies and services. Thus, incentive regulation provides greater incentive for these investments.

Q. Is incentive regulation appropriate for all telecommunications companies?

A. Incentive regulation is inappropriate for those rural carriers serving areas with limited growth, or even negative growth, due to out-migration of population. In situations of low or negative growth, carriers have limited opportunities to reduce costs and increase revenues. Nonetheless, these carriers are obligated to serve as carriers of last resort: they must maintain the network and the capability to serve all consumers in face of negative growth. Given the unfavorable demographics of these rural companies' service territories, these companies will have limited incentive to introduce new technologies and services unless they receive some assurance that they will have the opportunity to recover the costs of their investments in rates. Rate of return regulation provides this necessary assurance.

The Telecommunications Act of 1996

Q. Are you familiar with the Telecommunications Act of 1996 ("the Act")?

A. Yes, I am.

Q. What was the purpose of the Act?

A. Congress passed the Act to provide for a deregulatory and competitive structure for telecommunications markets and to assure the availability of basic and advanced telecommunications services to all regions of the country at comparable and affordable rates.

Q. How does the Act encourage competition in telecommunications markets?

A. The Act specifically removes all regulatory barriers to entry in telecommunications markets and requires incumbent carriers to: (1) interconnect their facilities with other telecommunications carriers; (2) provide non-discriminatory access to network elements

on an unbundled basis; (3) offer for re-sale at wholesale rates any service the carrier provides at retail; (4) provide number portability; (5) provide dialing parity to competing providers of local exchange and toll service; and (6) provide physical collocation of the equipment necessary for interconnection or access to unbundled network elements.

Q. Does the Act provide any exemptions to the above requirements for rural telephone companies?

A. Yes. Section 251(f) (1) provides an exemption from these requirements for rural telephone companies until such companies have received a bona fide request for interconnection and network elements, and the state has determined that the request is not economically burdensome, is technically feasible, and is consistent with the Act's universal service provisions. In addition, Section 251 (f) (2) allows states to suspend or modify the interconnection requirements for those companies with fewer than two percent of the nation's subscriber lines installed, in the aggregate, nationwide.

Q. Are there any other ways in which the Act treats rural telephone companies differently from other telephone companies?

A. Yes. Concerning universal service requirements, the Act treats rural telephone companies differently with respect to: (1) the number of providers eligible for universal services support [Section 214 (e) (2)]; (2) the definition of "service area" for the purpose of determining universal service support obligations and mechanisms [Section 214 (e) (5)]; and (3) the requirements imposed on competitive carriers as a condition of entry in rural markets [Section 253 (f)].

Q. How does the Act provide for the availability of basic and advanced telecommunications services to all regions of the country at affordable rates?

A. The Act relies primarily on deregulation and competition to achieve this policy goal. In addition, the Act establishes certain universal service principles that the Commission is required to implement. These universal service principles include: (1) quality services should be available at just, reasonable, and affordable rates; (2) basic and advanced telecommunications services should be provided in rural, insular, and high cost areas at rates that are reasonably comparable to rates charged in urban areas; (3) basic and advanced telecommunications services should be available at discounted rates to rural schools, libraries, and hospitals; (4) all providers of telecommunications services should contribute to the preservation and enhancement of universal service; and (5) universal service support should be explicit and sufficient to achieve these universal service goals.

Q. Why is universal service a desirable policy goal?

A. Universal service is desirable for two reasons. First, the benefit of telecommunications service to any one customer increases exponentially with the number of other customers that are connected to the network. Thus, it is beneficial to society for as many people to have telecommunications service as possible. Second, access to telecommunications service is a significant component of economic welfare. Those who do not have access to telecommunications service are significantly disadvantaged with respect both to their ability to consume and to their ability to advance in society.

The Commission's Regulatory Reform Program

Q. Has the Commission taken any steps to implement the Act's goals?

A. Yes. The Commission has taken numerous steps to: (1) develop pricing policies and regulations regarding interconnection, collocation, the purchase of unbundled network elements, and the resale of services provided at retail; (2) set standards for number

portability and dialing parity; (3) reform the system of interstate access charges; (4) establish a system of explicit and sufficient support for universal service; and (5) assure that rates for and availability of basic and advanced services in rural areas are reasonably comparable to rates and availability of basic and advanced services in urban areas. I limit my discussion to access reform, universal service support, and provision of high quality services in rural areas at comparable rates, because these issues are the major focus of the Plan.

Access Reform

Q. How are access charges currently determined for non-price cap LECs?

A. Access charges for the non-price cap LECs are currently determined in four steps. First, the non-price cap LECs must record all revenues, expenses, and investment in accordance with the Commission's Uniform System of Accounts. The non-price cap LECs must then divide their revenues, expenses, and investment into accounts associated with regulated and non-regulated services. Next, they determine the fraction of regulated expenses and investments that should be allocated to the interstate jurisdiction via the separations process (Part 36 of the Commission's Rules and Procedures). Finally, the Commission determines a set of interstate access rates that allows the non-price cap LECs to recover their interstate expenses and earn a fair rate of return on their interstate investment.

Q. How are the non-price cap LECs' regulated expenses and investment allocated to the interstate jurisdiction via the separations process?

A. The separations process recognizes that some facilities, such as private lines, are used exclusively for interstate services. The cost of these facilities are assigned entirely to the interstate jurisdiction. The process further recognizes that most of the non-price cap

LECs' telecommunications facilities are used to provide both interstate and intrastate services, and that the cost of these facilities can be classified as either traffic sensitive or non-traffic sensitive. As their names imply, traffic sensitive costs are those that depend on the amount of usage of telecommunications facilities, while non-traffic sensitive costs are those that must be incurred, even if the company's telecommunications facilities are not used. Traffic sensitive costs are allocated via the separations process on the basis of the relative percentage of intrastate and interstate minutes of use. Non-traffic sensitive costs are allocated 75 percent to intrastate, 25 percent to interstate.

Q. Have economists recognized any basic principles that should govern the pricing of interstate access services?

A. Yes. Economists have long recognized that the pricing of interstate access services should reflect the manner in which interstate access costs are incurred. Thus, traffic sensitive costs should be recovered through usage-sensitive rates, and non-traffic-sensitive costs should be recovered through flat rates. Economists have also recognized that there must be a margin above cost to cover overhead expenses.

Q. Does the Commission recognize the basic economic principle that access costs should be recovered in the same manner in which access costs are incurred?

A. Yes. The Commission recognized the basic economic principle that access costs should be recovered in the same manner in which they are incurred as early as 1983, when it issued its Order in MTS and WATS Market Structure, CC Docket No. 78-72, Third Report and order, Phase 1, 93 FCC 2d 241, *recon.*, 97 FCC 2d 682 (1983), *second recon.*, 97 FCC 2d 834 (1984). In that Order, the Commission stated its goal of gradually increasing end user access charges to the point where they fully recovered the non-traffic

sensitive costs of providing end user access. Subsequent political considerations caused the Commission to abandon this goal well short of the point where non-traffic sensitive costs were fully recovered through end user access charges. However, the Commission made further steps in the direction of recovering access costs more economically in its 1997 Access Reform Order. Finally, the Commission recognized this economic principle in the *Sixth Report And Order In CC Docket Nos. 96-262 And 94-1, Report and Order In CC Docket No. 99-249, Eleventh Report and Order In CC Docket No. 96-45,* issued May 31, 2000, when it stated at paragraph 12:

> In promulgating its access charge rules, the Commission has recognized that, to the extent possible, costs of interstate access should be recovered in the same way that they are incurred. This approach is consistent with principles of cost-causation and promotes economic efficiency. Thus, non-traffic-sensitive costs should be recovered through fixed, flat-rated fees. Similarly, traffic-sensitive costs should be recovered through corresponding per-minute access rates. The Commission's rules, however, are not fully consistent with this goal. In particular, because the Commission has taken a cautious approach in addressing affordability concerns, it has taken measured steps toward this goal by limiting the amount of the allocated interstate cost of a local loop that is assessed directly on residential and business customers as a flat monthly charge.

Universal Service

Q. What steps has the Commission taken to implement the universal service provisions of the Act?

A. The Commission has taken at least two steps to implement the universal service provisions of the Act. First, the Commission has established an explicit funding mechanism to fulfill the Act's requirement that advanced telecommunications services be made available at discounted rates to schools, libraries, and hospitals in rural areas. Second, the Commission has investigated a variety of models for determining the cost of providing telecommunications services in some rural areas. The Commission has

referred this issue to the Joint Board. Third, the Commission has established explicit funding mechanisms for Long Term Support and Local Switching Support. Previously, these support dollars were implicit subsidies built into interstate access rates. Fourth, the Commission has approved a plan put forth by the Coalition for Affordable Local and Long Distance Service ("CALLS") to reduce implicit subsidies in access rates and provide an explicit and sufficient means of supporting universal service.

The CALLS Plan

Q. Are you familiar with the CALLS Plan?

A. Yes, I am.

Q. What are the major features of the CALLS Plan?

A. The CALLS plan has the following features:

- Increases the primary residential and single line business subscriber line charge ("SLC") caps to $4.35 on July 1, 2000, and gradually increases the SLC caps thereafter to $6.50 on July 1, 2003;
- Removes $650 million in implicit universal service support from carrier access charges;
- Creates an explicit portable interstate access universal service support mechanism;
- Eliminates the residential PICC;
- Requires IXCs to flow through reductions in access rates to residential and business customers;
- Temporarily eliminates minimum usage rates for low-usage customers by long distance carriers; and
- Provides additional lifeline assistance to low income customers to protect them from increases in the residential SLC.

Q. How does the CALLS plan address the Commission's economic policy goals in the areas of access reform and universal service?

A. The CALLS plan directly achieves the Commission's goals of recovering access costs in the same manner in which they are incurred, removing implicit subsidies embedded in carrier access rates, and assuring explicit and sufficient support for universal service.

Q. Does the CALLS plan apply to rate of return regulated companies?

A. No. The CALLS plan does not apply to rate of return regulated companies. However, the CALLS plan affects the rate of return regulated companies because it increases the disparity in the access rates charged by the rate of return and price cap LECs, and increases the pressure on interexchange carriers to de-average interstate toll rates, contrary to Section 254 (g) of the Act.

The Plan

Q. Are you familiar with the Plan?

A. Yes, I am.

Q. What is the purpose of the Plan?

A. The Plan seeks to provide a comprehensive and integrated solution to outstanding regulatory issues in the areas of interstate access, universal service support, separations, and rate of return.

Q. What are the major features of the Plan?

A. The Plan has the following features:

- Allows participating companies to choose between incentive regulation (Path A), and rate of return regulation (Path B), over a reasonable transition period.[1]
- Reduces Path A carrier access rates to a prescribed $0.016 composite average level.
- Increases the SLC for Path A and Path B companies to the prevailing CALLS' companies cap under the CALLS plan.
- Removes current ceilings on universal service support.

[1] Companies that initially choose Path B also have an opportunity to shift to incentive regulation during the first five years of the Plan. At the end of the five-year transition period, however, Path B companies must apply for a waiver from the Commission to move to incentive regulation. Plan participants expect that companies with the majority of access lines will choose the incentive regulation option by the end of the transition period.

- Creates an explicit and sufficient system of universal service support to replace implicit subsidies in current access rates.
- Requires long distance carriers to flow-through reductions in access rates to residential and business customers.
- Adjusts lifeline assistance support to shield low-income customers from increases in residential SLCs.
- Retains the current 25 percent non-traffic sensitive interstate allocation factor and 11.25 percent interstate allowed rate of return on investment.
- Includes a low-end adjustment feature that is similar to the current low-end adjustment feature for the price cap LECs.

Q. What are the primary economic benefits of the Plan?

A. The Plan has numerous economic benefits. First, the Plan reduces, and in some cases eliminates, the implicit subsidies in the current access charge system for non-price cap LECs. Second, the Plan provides explicit and sufficient support for universal service, as required by the Act. Third, as also required by the Act, the Plan assures that rural telecom customers will have access to high quality telecommunications services at rates that are reasonably comparable to those charged in urban areas. Fourth, the Plan provides incentives for the Path A non-price cap LECs to reduce costs, expand services, and increase investments in new telecommunications technologies in rural areas through a form of incentive regulation that, although different from price caps, is compatible with the pooling environment. Fifth, the Plan eliminates the time and expense of litigating the complex, outstanding regulatory issues in the areas of access charges, universal service, separations, and rate of return. Finally, the Plan encourages telecommunications competition in rural areas.

Reduction of Implicit Subsidies

Q. How does the Plan reduce the implicit subsidies in the current access charge system for non-price cap LECs?

A. By gradually increasing the subscriber line charge to the caps stated in the CALLS Plan, the Plan allows a significantly higher percentage of non-traffic sensitive costs to be recovered through flat end user fees. Since the shortfall in recovery of non-traffic sensitive costs has previously been covered by usage sensitive carrier common line charges, the Plan allows for a significant reduction in carrier access rates over the life of the plan. Thus, the Plan moves towards recovering traffic sensitive costs with usage based rates, and non-traffic sensitive costs with flat rates.

Q. Does the Plan address the Commission's concerns regarding implicit subsidies?

A. Yes. As the Commission recognized in Paragraphs 26—28 of the CALLS Order, however, the task of determining the cost of providing service in every area of the country is both difficult and time consuming, and the methods that should be used to determine the cost of providing access are highly controversial. Yet, there is common agreement that carrier access rates are currently above the traffic sensitive cost of providing access, and subscriber line charges are currently below the non-traffic sensitive cost of providing access. Furthermore, subscriber line charges in high cost rural areas simply cannot increase to the point of recovering non-traffic sensitive costs without impairing the affordability of telecommunications service in high cost rural areas, and violating the Act's principle of comparability. In this environment, it is preferable to accept a comprehensive consensual approach that moves in the right direction, rather than to endlessly debate the complex issues involved in implementing access and

universal service reform.[2] The Plan offers such a comprehensive approach to access and universal service reform that takes reasonable steps in the right direction.

Q. Are the Plan's reductions in per-minute carrier access rates and increases in SLCs similar to those the Commission has previously approved in the CALLS Order?

A. Yes. The reductions in per-minute carrier access rates in the Plan are proportional to the reductions in carrier access rates already approved by the Commission. In addition, the Plan requires non-price cap LECs to increase their SLCs up to the capped levels allowed in the CALLS Plan. Thus, the Plan's reductions in carrier access rates and increases in SLCs are very similar to access changes the Commission has already approved.

Explicit and Sufficient Support for Universal Service

Q. How does the Plan provide explicit and sufficient support for universal service?

A. The Plan provides explicit and sufficient support for universal service through the removal of the cap on high cost support and the creation of a Rate Averaging Support ("RAS") mechanism that is designed to recover the shortfall between the Path A non-price cap pooling LECs' total interstate revenue requirement and the amounts they collect in carrier access rates, subscriber line charges, and existing universal service support mechanisms. Universal service support under the RAS mechanism will be collected in the same manner as universal support under the Commission's current universal service support programs.

Q. Are the universal service support payments provided by the RAS portable?

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[2] As the Commission states in Paragraph 28 of the CALLS Order, "It is this comprehensive solution of historically contentious issues that allows us to take these actions while ensuring that consumers in high-cost areas will continue to have affordable service." *Sixth Report And Order In CC Docket Nos. 96-262 and 94-1, Report and Order*

A. Yes. The RAS support payments are portable to all eligible telecommunications carriers.

Assurance of Comparable Rates

Q. How does the Plan assure that rates for telecommunications services in rural areas will be reasonably comparable to those in urban areas?

A. The Plan assures that rates for telecommunications services in rural areas will be reasonably comparable to those in urban areas in several ways. First, the Plan reduces the non-price cap LECs' carrier access rates in proportion to the reductions in carrier access rates identified in the CALLS Plan. Second, the Plan requires interexchange carriers to pass through reductions in carrier access rates to toll customers in the non-price cap LECs' primarily rural areas, and to provide all of their rate plans ubiquitously to both urban and rural customers. Third, the Plan requires interexchange carriers to abandon their plans to geographically de-average toll rates and to adhere to the Act's requirement that: (1) rates for interexchange services in rural and high cost areas be no higher than rates for such services in urban areas; (2) customers in rural, insular, and high cost areas have access to interexchange services that are reasonably comparable to interexchange services provided in urban areas; and (3) rates for interexchange services must be reasonable comparable to rates for similar services in urban areas. Fourth, the Plan requires increases in the subscriber line charges up to the capped levels of those specified in the CALLS plan. Since a majority of the urban access lines are served by CALLS Plan participants, SLC charges in rural areas as proposed in the Plan will be reasonably comparable to those in urban areas.

In CC Docket No. 99-249, Eleventh Report And Order In CC Docket No. 96-45, issued May 31, 2000.

Enhanced Incentives for Efficiency and Investment in New Technologies

Q. How does the Plan provide enhanced incentives for efficiency and investment in new technologies?

A. The Plan offers three sources of enhanced incentives for efficiency and investment in new technologies. First, the Plan requires the non-price cap LECs who choose Path A to move to incentive regulation by the end of a five-year transition period. Prior to the end of the five-year transition period, Path A companies can move to incentive regulation on an individual study area basis. As noted above, incentive regulation provides enhanced incentives for cost reduction and investment in new technologies by breaking the link between a company's costs and its revenues. If a company is able to reduce its costs through increased efficiency or investment in new technologies, its profits will increase.

Second, the Plan removes the current cap on high cost loop support. Rural telephone companies are a very diverse group. Many are very small companies that serve areas with declining population. These companies simply do not have the financial resources to maintain and upgrade their plant under the current limits on high cost loop support. Removing these limits will allow the rural telephone companies to invest in the new technologies required to bring high quality telecommunications service to rural areas.

Third, the Plan offers an opportunity to settle many complex regulatory issues in the areas of interstate access, universal service support, separations, and rate of return. By settling these issues, the Plan will produce a more stable environment for telecommunications investment by the non-price cap LECs. The risk caused by massive

upcoming regulatory changes has encouraged companies in rural study areas to postpone investment. Adoption of the Plan will reduce the uncertainty about these changes.

Q. How will the incentive regulation feature of the Plan work?

A. Under the Plan, all companies choosing incentive regulation will eventually settle with the NECA pool on the basis of a fixed Revenue Per Line ("RPL"). The initial RPL will be based on the most recent cost study or average schedule revenue requirement data prior to conversion to incentive regulation, adjusted for inflation. In all subsequent years, the RPL would be adjusted annually to reflect changes in inflation. Thus, the revenue requirements of these companies will be targeted to inflation rather than to changes in company-specific expenses and investments.

Q. Is it reasonable to adjust the RPL to reflect inflation?

A. Yes. An inflation adjustment is a common feature of incentive regulation plans in the telecommunications industry. For example, the FCC has included an inflation adjustment in its price cap plan for the price cap LECs, and the Rural Task Force has included an inflation adjustment in its final recommendations for universal service support (see Section IV, B, 1, *Rural Task Force Recommendation to the Federal-State Joint Board on Universal Service*, adopted September 22, 2000). The Rural Task Force recognized that universal service funding must be adjusted for both line growth and inflation if rural carriers are to have an incentive to make the infrastructure investments required to provide access to advanced services:

> The federal universal service support fund should be sized so that it presents no barriers to investment in plant needed to provide access to advanced services. Specifically, to remain "sufficient" under the 1996 Act, the fund should be sized so that investment in rural infrastructure will be permitted to grow. [Section IV, A, 1, c.]

Q. Please describe the Low End Adjustment ("LEA") feature of the Plan.

A. The LEA feature allows all non-price cap LECs with study areas earning a return on equity of less than 10.25 percent in any rate period to receive payments from the NECA pool in twelve equal installments over the following period that are sufficient to bring the prior year's earned rate of return in that study area up to 10.25 percent. For those carriers with five or fewer study areas, the LEA feature allows payments from the NECA pool sufficient to bring the prior year's rate of return up to 10.75 percent if the LEC can demonstrate that the rate of return for a study area during the previous year was less than 10.75 percent.

Q. How does the LEA feature assure that Path A non-price cap carriers have an incentive to reduce costs and invest in new telecommunications technologies and services?

A. Most non-price cap carriers operate in high cost low-density rural areas that are both costly and difficult to serve. Non-price cap LECs are unlikely to make investments in new telecommunications services and technologies in these areas without some backstop rate of return on their investment. By supplying this backstop, the LEA feature provides an incentive for the Path A non-price cap LECs to take the risk of investing in their high cost service territories. In this regard, the LEA feature of the Plan is similar to the protections already enjoyed by the price cap LECs.

Q. The Plan calls for continuation of the current 11.25 percent rate of return on investment. How does this feature affect the Plan participants?

A. The Plan signatories anticipate that the majority of non-price cap access lines will move to incentive regulation within the five-year transition period of the plan. For the companies choosing incentive regulation, the 11.25 percent rate of return primarily affects the level of the LEA. For those carriers who choose to continue under rate of

return regulation, the 11.25 percent rate of return will also affect the revenues they are allowed to achieve over the life of the plan.

Q. Why is the continuation of the current 11.25 percent rate of return an important feature of the Plan?

A. Investments in telecommunications facilities are long-term investments that cannot be reversed. The non-price cap LECs will be more likely to invest in new telecommunications facilities if they can be reasonably assured that they will have an opportunity to earn an adequate return on their investment over the life of the facilities. By continuing the current 11.25 percent authorized rate of return, the Commission can reduce the uncertainty about the prospective returns the non-price cap LECs are likely to achieve on investments in new telecommunications technologies and services. Thus, the non-price cap LECs will be more likely to invest in new telecommunications technologies and services if the Commission affirms the current 11.25 percent allowed rate of return on investment.

Q. Do you have any evidence that 11.25 percent is a reasonable rate of return for the non-price cap LECs?

A. Yes. I provided evidence in CC Docket 98-166, filed on January 19, March 16, and April 8, 1999, that the non-price cap LECs cost of capital exceeds the Commission's currently authorized 11.25 percent allowed rate of return on investment.

Encouraging Competition in Rural Areas

Q. What is the economically preferable avenue of competition in areas served by rural telecommunications companies?

A. Facilities-based competition is undoubtedly the economically preferable avenue of competition in areas served by rural telecommunications companies. Under facilities-based competition, competitors compete on the cost and quality of the entire set of telecommunications services offered to customers. However, facilities-based competition for telecommunications services in rural areas is difficult to achieve.

Q. Why is facilities-based competition for rural telecommunications services difficult to achieve?

A. Facilities-based competition for rural telecommunications services is difficult to achieve because the subscriber line charge is currently significantly below the non-traffic sensitive cost of providing telecommunications service in high cost rural areas. In addition, some of the remaining implicit support in the pricing of access has not been made explicit. Thus, potential competitors are unlikely to find it to be profitable to invest in alternative telecommunications facilities in high cost areas.

Q. How does the Plan improve the prospects for facilities-based competition?

A. The Plan has two features which significantly improve the prospects of facilities-based competition in the mostly rural non-price cap LECs' service territories. First, by significantly increasing the level of the SLCs, the Plan allows the SLCs to more closely approximate the non-traffic sensitive cost of providing telecommunications service in these high cost areas. Second, by providing additional portable subsidies for eligible telecommunications carriers, the Plan provides the prospect that competitors can receive revenues sufficient to cover the costs of building their own facilities.

Recommendation

Q. What is your recommendation with regard to the Plan?

A. I recommend that the Commission adopt the Plan in its entirety. The Plan offers significant incentives for the non-price cap LECs to reduce costs and invest in new telecommunications services and technologies. By bringing prices more in line with costs, the Plan also provides clearer price signals to customers and encourages competition in the non-price cap LECs' service territories. Finally, the Plan provides an explicit, portable, and sufficient universal support mechanism for telecommunications services in rural, insular, and high cost areas. Thus, the Plan assures that customers in these areas will have access to advanced telecommunications services at rates that are reasonably comparable to those charged in urban areas.

I declare under penalty of perjury that the foregoing is true and correct. Executed on October 17, 2000.

James H. Vander Weide